

# **Martin Wheatley Speech – Wheatley Review Final Report event 28/09/12**

## **Introduction**

Good morning and thank you all for coming today.

Firstly I want to thank the Financial Secretary for his introduction. I also want to thank the Lord Mayor for allowing us to host this morning's event here in the heart of the City of London, a place built on a strong foundation of confidence and trust.

Confidence and trust are critical to financial markets. Whether it is something common-place like opening bank accounts or something as previously obscure as the London Interbank Offered Rate, or LIBOR. We need finance to work well – for consumers from all walks of life.

The reason we are here however is that we have been misled. The system is broken and needs a complete overhaul. The disturbing events we have uncovered in the manipulation of LIBOR have severely damaged our confidence and our trust – it has torn the very fabric that our financial system is built on.

Today we press the reset button, we need to:

- get back to what this reference rate is supposed to do;
- restore integrity to a globally important benchmark;
- make sure we get to a position where individuals act with integrity.

This is not a London issue. This is a global issue and is why I have been working in partnership with my counterparts in the US, Japan, Switzerland, the EU and elsewhere.

For my part, when the Chancellor of the Exchequer asked me to carry out this review on behalf of the UK Government; I was clear about the absolute importance, scale and challenge of this task. The shocking behaviour exposed by the FSA and others demonstrated that an independent review of LIBOR was needed.

We have carried out that work, with a thorough and considered look at what went wrong and what should be done to put things right.

But pressing reset is not as simple as pushing a button. Today I am publishing a 10-point plan for extensive and lasting reform of a broken system to restore the trust that has been lost. LIBOR

needs to get back to doing what it is supposed to do, rather than what unscrupulous traders and individuals in banks wanted it to do.

First and foremost, I have concluded that LIBOR can be fixed through a comprehensive and far-reaching programme of reform. Although the current system is broken, it is not beyond repair, and it is up to us – regulators and market participants – to work together towards a lasting and sustainable solution.

LIBOR is used in a vast number of financial transactions; with a value of at least \$300 trillion. The deep entrenchment of LIBOR as a reference rate in financial markets, and the subsequent effect on those markets in the event of a disruption to the rate, mean that any case for replacement entirely would have to prove that LIBOR is:

- beyond repair,
- that a better alternative existed at this moment in time,
- and critically, that an immediate and smooth transition to that alternative could be made.

I have concluded that none of these conditions have been met and that instead there is a clear case for comprehensively reforming LIBOR, rather than replacing it.

Secondly, I have concluded that LIBOR submissions should be supported by relevant trade data and proper record keeping.

Some degree of judgement will have to be retained, because even in the more liquid markets there is not enough daily data available to have a system in place that is entirely based on market transactions, particularly in times of stress.

But we can't allow the unfettered latitude that banks enjoyed previously. Much greater rigour and transparency must be introduced to the process of submission. Let me return to this point later.

And third, we must remember that LIBOR is a creation of the market, invented by the market for the market. It is clear that proper regulation and sanctions are needed and we stand ready to provide that, should the Government agree. But banks and market participants must play their part too.

My recommendations combine both long-term and immediate changes, which I will explain in detail.

The three broad areas that these recommendations cover are:

1. Regulation – Introducing a new regulatory structure for LIBOR, including criminal sanctions for those who attempt to manipulate it.
2. Governance – Transferring the oversight and governance role from the British Bankers' Association.
3. The rate itself – A range of technical changes to make the system work better, including streamlining a lot of the currencies and maturities currently used.

Today we begin to put this right. This responsibility will be taken forward by the new Financial Conduct Authority – which I will lead – and which will focus on making sure that financial services and markets function well, by promoting market integrity, consumer protection and effective competition.

Ensuring that the UK financial services sector conducts its business in line with the highest standards of integrity is vital work.

Consumers and market participants must be sure that the regulators stand ready to deal quickly and effectively with issues

as they arise – our work on LIBOR over the last seven weeks is testament to this new approach.

There are three things I want to cover today:

- Why LIBOR is so important
- What went wrong
- What is needed to restore confidence in LIBOR

## **1. So first, why is LIBOR so important?**

Since the scandal came to light, we have all become aware of LIBOR, once an obscure benchmark, and its importance as an integral part of the modern financial system.

What struck me when the manipulation was made public was how much it angered people – they were rightly upset that something so important was so badly run, had such poor governance, and was manipulated without regard to the consequences. It said something about the culture of financial services, but also led people to question what they can rely on.

As I have mentioned, LIBOR is used as a reference price for well over \$300 trillion worth of loans and transactions around the

world. These range from interest rate swaps – to direct lending and the pricing of mortgages to ordinary people, as well as commercial loans to businesses.

The Economist calls LIBOR the most important figure in finance, and they are not wrong. In simple terms – it represents the cost of borrowing to banks. How much a bank has to pay to borrow money is a key determinant of the interest it will charge to lend money. It is therefore vital that people can trust it. And that is why it is critical that it works well and my recommended reforms are deep, wide and effective to ensure that the trust and integrity of LIBOR is fully restored, and quickly.

## **2. So that's why it matters – now what went wrong?**

I would like to step back for a moment and briefly explain exactly what went wrong with LIBOR – I will then link each of my recommendations back to these failings.

There were fundamental flaws in the current system. These were the deep failures in the way LIBOR submissions are made, how LIBOR was governed, and the way it was policed.

### Submissions

The key flaw was the inability in the system to manage conflicts of interest. The rate is meant to represent the true cost of borrowing to a bank. Two problems occurred. First, any complex bank has a myriad of different deals, particularly in the swaps market – which became more or less profitable depending on the rate of LIBOR. Traders whose bonuses depended on these deals – had an interest in pushing LIBOR up or down, depending on the deal. They were allowed to do this freely with no oversight.

The second problem was that, at the height of the crisis in 2008, nobody knew which banks were safe. The price a bank had to pay to borrow from another bank was an indicator of what banks thought of each other. Nobody wanted to be at the top of that list so again there was an incentive to lie and put in a lower figure. This was made more complex by the fact that at the time, banks effectively stopped lending to each other. So there were very few actual trades to inform the decision.

Banks were further encouraged to make it look like their borrowing costs were lower than they actually were because the transparency in the system contained a fatal flaw: banks'



individual submissions were published immediately. This gave an instant indication of their creditworthiness.

What's more and worse, is that we are not talking about a few rogue individuals here, but a systemic problem. In the case of Barclays for example there was a web of traders that worked together to try and manipulate LIBOR to benefit one another.

To sum up, the system had in-built conflicts of interest from the start – banks could submit what they wanted – and with traders' bonuses dependent on the LIBOR rate, and no bank wanting to be seen as vulnerable in such a transparent system, too many people had a vested interest in gaming the system.

### Lack of oversight

The second fundamental flaw was a lack of oversight.

As we all know the British Bankers' Association is currently responsible for the day-to-day running of LIBOR. Oversight of LIBOR is the responsibility of a committee set up by the BBA with two subcommittees looking at unresolved problems and disciplinary procedures respectively. The only problem is that these committees hardly ever met.

This is symptomatic of a careless approach that did not place enough emphasis on the importance of LIBOR from both a governance and regulatory perspective – essentially, people had an overt level of trust in a system that did not have the right level of checks and balances in place.

And the contributing banks themselves? What did they do? One bank we know of made no effort at all to aid credible submissions and has now paid the price. Other banks will follow.

Organisations and individuals were basically left unchecked and were free to act without scrutiny, leading to abuse of the system – they essentially exploited the lack of checks and balances. This is not good enough –just because the system provided that opportunity, society does not expect institutions with proud histories and millions of customers around the world to take advantage of it.

It is clear to me that, while the system lacked the right level of oversight, contributing banks also need to stand up and take responsibility for the quality of the submissions they make to the LIBOR process.

### Lack of external accountability

Let me turn to the final flaw in the current system – the lack of external accountability.

Under the current regulatory and legal framework, the FSA does not regulate the process of making or compiling Libor submissions. While the FSA is currently taking regulatory action in relation to attempted manipulation of LIBOR, this is on the basis of the connection between LIBOR submitting and other regulated activities

Further, because of this, individual employees of banks involved in the process do not have to be approved by the FSA. This restricts the regulator's ability to take disciplinary action against individuals.

In hindsight, it now appears untenable for such an important process to be unregulated.

So this is the final lesson. There is a clear lack of external accountability to safeguard that the incentives of those involved in this process are aligned with the wider interests of market participants, benchmark users and the public. Added to this,

there is a lack of a comprehensive sanctions regime to ensure that those who manipulated the rate are brought to book.

Overall then, the evidence we have seen in relation to this manipulation paints a clear and damning picture about the prevalence of the wrong incentives, and the sorts of behaviour that has allowed.

Whilst conduct in the banking industry at large is rightly a separate and ongoing debate, my mandate is clear – reform is needed to prevent the possibility of this gross misconduct from reoccurring – both in how LIBOR is constructed, and how it is overseen and enforced.

My team and I have addressed each of these failings in the recommendations that I will set out for you now.

### **3. The Wheatley Review recommendations**

#### **Consultation**

Following the launch of my discussion paper on August the 10<sup>th</sup> we have met with a large number of stakeholders, and considered the many written responses that we received.

I would like to offer my thanks to all those involved for their timely and thought-provoking engagement with the Review.

Having considered all the issues and evidence in detail, let me turn to the steps that should be taken to ensure that LIBOR becomes a relevant, valued and trusted benchmark.

The report sets out a comprehensive 10-point-plan to fix LIBOR. This is through reforms to put a stop to what is a broken system built on flawed incentives, incompetence and the pursuit of narrow interests that are to the detriment of markets, investors and ordinary people.

### (i.) Regulation of LIBOR

The first step for credibly reforming LIBOR is to ensure that there is a clear, consistent and effective regulatory regime that underpins all activity.

This would allow the FSA to take action against those who break the rules, and provide confidence that misconduct will not be left unseen or unpunished.

In the light of recent evidence, it is clear that better and stronger regulatory tools are needed to crack down on such unacceptable behaviour.

I am recommending three specific regulatory changes to achieve these goals:

- First, submission and administration of LIBOR should become regulated by the FSA;
- Second, the key individuals in these processes should be FSA approved persons; and,
- Finally, amend the Financial Services and Markets Act to allow the FSA to prosecute manipulation or attempted manipulation of LIBOR.

Bringing the submission and administration of LIBOR under the FSA's regulatory umbrella will enhance the FSA's ability to:

- Put in place rules that set out requirements on firms to ensure the integrity of the submission process.
- Allow the FSA to supervise the conduct of firms and individuals involved in the process,
- Critically, the FSA will be able to take regulatory action against firms and approved persons in relation to misconduct, including public censure and financial penalties.

Many of the problems we have seen are down to the behaviour of individuals. These powers will allow the FSA to approve key individuals for these roles, ensuring that they are fit and proper to perform the job, something which is clearly lacking in the present system.

As part of this process, my final recommendation is to amend the Financial Services and Markets Act to include, as an offence, the making of a false or misleading statement in order to manipulate LIBOR. This would enable the FSA to use criminal powers for the worst cases of attempted manipulation.

These powers to take action against wrongdoers will be in addition to the powers under the new European market abuse regime. The European Commission has acted quickly to amend this new regime so that it will apply to manipulation of benchmarks.

The UK Government should continue to assist in finalising the new Market Abuse Regulation, which will apply across Europe, and bring another level of protection against manipulation.

#### (ii.) Institutional reform

But statutory regulation – while vitally important in providing assurance and confidence in the process – is not a panacea.

Whilst the changes to the regulatory regime I have outlined will provide a sizeable and robust foundation for reform, it is equally important that the governance and oversight of LIBOR is overhauled.

To achieve this I recommend that:

The British Bankers Association clearly failed to properly oversee the LIBOR setting process and should take no further role in the administration and governance of LIBOR. Responsibility should



be transferred to a new administrator. We are today starting an open tender process to invite organisations to take over the running of LIBOR. I am confident that there are a number who are willing to take it on and meet my expectations regarding the new institutional model of governance and oversight, which I have set out in detail in my report.

The process of transition to a new body is crucial; and it must be open, transparent and efficient, to ensure fairness and minimum disruption and volatility in markets. We must also ensure that the process delivers on restoring trust in the running of LIBOR.

As I have recommended in my report, there should be a tender process to be run by an independent committee convened by the regulatory authorities.

I am very pleased to be able to announce that Lady Sarah Hogg, chairman of the Financial Reporting Council, has agreed in principle to chair this panel once it is established. Sarah brings an unparalleled depth and breadth of experience in corporate governance, regulation, public policy and financial services to this

crucial task, and I can't think of any one better placed to lead it. I am delighted she has agreed to take this on.

The new administrator should fulfil specific obligations such as surveillance and scrutiny of submissions as part of its governance and oversight of the rate.

Broadly, I expect that new institutions should demonstrate much greater independence, with a clear distance between institutions and submitting banks. A specific oversight process also needs to be set up at administration, governance and bank levels. There must also be transparent systems, processes and structures, with clear accountabilities at every level.

It is essential that the conduct of the new administrator should be rigorous and transparent, in order that they cleanse the toxic brand of LIBOR, and generate trust in the process moving forward.

### (iii.). The rules for governing LIBOR

Earlier I outlined the need to retain some level of judgement. But judgement needs to be explicitly and transparently linked to trade data wherever possible.

A number of my recommendations are therefore intended to establish strict and detailed processes for verifying submissions against hard data.

I expect that the first priority of the new administrator should be to introduce a code of conduct for submitters. This code of conduct should introduce specific guidelines prescribing that submissions be corroborated by trade data.

Submitting firms will be subject to new tough systems and controls that will be put in place. Transactions will need to be recorded and there needs to be a requirement for regular external audit of submitting firms.

The market also needs to know whether a submission has been made based on transactions or not.

Only with such rules and guidance can we ensure that the process has the much needed integrity.

Once the regulatory regime which I have described is up and running, this code of conduct should become industry-led, and regulator approved guidance.

Until this tender process has concluded, submitting banks should move to compliance with the submission guidelines presented in this report.

#### (iv.) Immediate Improvements to LIBOR

The recommendations that I have set out so far, are designed to generate extensive and lasting reform.

But a comprehensive approach to reforming LIBOR inevitably requires changes to be made immediately. LIBOR as a reference rate continues to function as we speak. So what changes should be made now, to strengthen the rate as quickly as possible?

My report sets out a number of recommendations for immediate changes to the way in which LIBOR is derived, designed to establish a link between transactions and submissions, something advocated by many stakeholders as a way of enhancing credibility.

We examined the volume of transactions underpinning each LIBOR benchmark and the variance across different maturities and currencies. Some of these contained very few trades and some LIBOR benchmarks are used for very few transactions.

I therefore recommend that the BBA, and in due course the new administrator, should remove those currencies and tenors from LIBOR, which lack a sufficient amount of trade data to corroborate submissions – we aim to phase out these rates over the next 12 months or sooner, where possible.

In particular, Australian, Canadian and New Zealand Dollars, as well as Swedish and Danish Krone will be phased out. We also aim to reduce the maturities published by removing some of the intermediate tenors, such as four, five; seven, eight; ten and eleven months. This emphasis on the liquid segments of the market will further strengthen the link between submissions and observable transactions. This will reduce the current number of LIBOR reference rates – 150 – down to 20 where we are confident there is a real market to underpin the rates.

As I explained the publication of individual submissions by banks – a measure that was originally intended to enhance transparency, has paradoxically facilitated manipulation. These details will remain available to the oversight committee, administrator, and the FSA for the purpose of oversight and scrutiny. I appreciate that this may be seen as a slight reduction in immediate transparency, but to rectify this, we have

recommended the regular publication of a statistical bulletin, including trading volumes and values for the inter-bank funding market.

I am recommending that publication of individual submission~~s~~ is delayed by at least 3 months on a rolling basis, with the information remaining available to the oversight committee, the new rate administrator, and the FSA.

It is clear that there is a large gap between the number of banks which submit to the LIBOR process, and the number who use LIBOR as a reference rate, which has created a free rider problem. This is an issue which I consider should be quickly resolved.

Not only would an increased number of submissions help inform the LIBOR rate, which is supposed to represent the market as a whole, it would also discourage manipulation.

Subsequently I am recommending that relevant banks who do not currently submit, should be encouraged to participate as widely as possible in the LIBOR compilation process, including, if necessary, through new powers of regulatory compulsion. LIBOR requires collective responsibility if it is to work effectively.

Finally, market participants should be encouraged to consider and examine their present use of LIBOR as a reference rate. Is it the most appropriate reference rate for transactions that they undertake? Or are the other benchmark rates that are more appropriate?

#### (v.) Alternatives for LIBOR in the longer term

My report also considers the viability of alternatives to LIBOR in the longer term. Specifically, if there is a case for and environment where a variety of viable alternatives to LIBOR could exist simultaneously.

It also analyses the case for involvement of the authorities in any move towards either a replacement to LIBOR, or a plurality of alternatives. And finally, it sets out the most plausible candidate alternative benchmarks that were presented in my Discussion Paper, and examining each in more detail.

However it is clear that there is widespread debate ongoing in the international community, concerning the appropriate role of authorities around the globe in regard to a variety of benchmark rates. And several international organizations will be examining and recommending approaches to these issues.

I recommend in my report that international authorities should take forward a discussion of existing applications of interbank rates such as LIBOR, the merits of alternative reference rates for certain applications, and the role – if any – that the authorities should play in facilitating transition to these reference rates for future contracts.

In the first instance I believe that this discussion should be guided and co-ordinated by the Financial Stability Board (FSB), working in conjunction with IOSCO, the European Commission and other interested international institutions such as the Bank of International Settlements.

### **Implications for Other Benchmarks**

While today is about LIBOR, it is of course only one of a number of important benchmarks that are used in contracts around the world. And some commentators have already put the spotlight on other major international benchmarks, for example there has already been a substantial amount of work on Price Reporting Agencies in the oil market, led by IOSCO.

Further, there are a large number of other important benchmarks in other commodity markets – for example for the prices of



agricultural products and precious metals – and in the equity, bond and money markets, which have not yet been re-assessed, but which may need to be looked at given the current scrutiny of benchmarks.

Whilst other benchmarks vary greatly in design and application, I hope that those responsible for them will be able to draw some important lessons from my report on LIBOR, and that it will help stimulate wider debate on benchmarks.

In particular, I consider that it should be possible to develop a set of overarching principles that can be applied to all major benchmarks, to promote robustness and credibility across the markets. In my report I have set out some basic features that in my view any major benchmark should have .

Many of these benchmarks are compiled in different parts of the world, and many are applied to contracts all over the world, so naturally I would expect that any such work is co-ordinated at the international level. My Report outlines the various pieces of work that are already underway in different parts of the world.

As many of you will know, Gary Gensler, Chairman of the Commodity Futures Trading Commission, and I will co-chair an

IOSCO task force. We believe this task force will provide a useful vehicle to help advance this important work. Crucially, this IOSCO task force will be informed by the European Commission's work on Regulation of Indices, as well as IOSCO's Principles for Oil Price Reporting Agencies.

The European Commission has launched another important strand of work on the use and possible regulation of major benchmarks in Europe.

It is only through team work and collaboration that the various authorities and bodies will develop effective and lasting solutions to these issues.

I look forward to working with Chairman Gensler on this crucial aspect of international work; as well as with other international institutions such as the Financial Stability Board and key European institutions.

Domestically, my report also considers some examples of other important benchmarks that are UK-related and recommends that further work be taken forward by the UK authorities with respect to benchmarks that are compiled in the UK or relate to Sterling products.

## Concluding Remarks

In closing, I would like to reflect on the range of issues covered today.

The evidence backs a strong case for reforming LIBOR.

Governance of LIBOR has completely failed resulting in the sort of shameful behaviour that we have seen. This problem has been exacerbated by a lack of regulation and a comprehensive mechanism to punish those who manipulate the system.

That is why I am recommending that the FSA is given clear and extensive powers to ensure that regulation is able to cover the offences, and that there is enough clout to punish those who break the law.

But this regulatory foundation must serve as the last line of defence, behind an overhauled governance structure, with a new, independent body, backed by a clear code of conduct, with clear rules and procedures regarding submission.

These changes will ensure that the market can once again have confidence in LIBOR going forward, and that the public both in

Britain and abroad, are reassured that this problem will not happen again.

There is still much work to be done on an international level in regard to the appropriate use of benchmarks in all markets, and the appropriate rules and regulations that should be applied. I encourage those bodies to consider and respond to this report.

Together, we need to get this right so that people and businesses can depend on a system that works, with good regulatory oversight, governance and reliable information. I submit this review to the Government for its consideration, and look forward to their response in due course.

Thank you.